

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA

In re  
CAPITAL WEST INVESTORS, a California  
Limited Partnership,  
Debtor.

Case No. 93-53365-MM  
Chapter 11

**MEMORANDUM DECISION AND  
ORDER THEREON**

Employer's Tax Identification No. 77-0060385

**INTRODUCTION**

This is the Court's tentative ruling pending the debtor's technical changes to the proposed plan of reorganization. This shall become the Court's ruling unless the technical changes contemplated by the debtor significantly affect the feasibility of the debtor's plan.

Before the Court for consideration is confirmation of the debtor's plan. At issue is whether the debtor's proposed interest rate provides Trilex Financial Services, the holder of the second trust deed, with the present value of its secured claim under Bankruptcy Code § 1129(b)(2)(A). Based on the evidence, the Court concludes that the plan provides Trilex with a market rate of interest. The debtor's plan is confirmed, and the objection of Trilex is overruled.

**FACTS**

The debtor is a limited partnership that owns and operates The Woods Apartments, a 160-unit apartment complex located at 40640 High Street in Fremont, CA. The debtor purchased the subject property in February 1985 for \$8.4 million. The property is now appraised at \$7.8 million to \$8.4 million.

1 The debtor filed its chapter 11 petition on May 21, 1993 because it is unable to raise rents in this market  
2 sufficient to service the debts on the property secured by three deeds of trust.

3 The first deed of trust on the property in favor of Reilly Mortgage currently secures a claim in the  
4 approximate amount of \$2,630,000. This is a HUD first deed of trust, with the typical restrictions,  
5 except that the debtor's proposed plan alters the terms of the note by eliminating the mortgage insurance  
6 and certain of the "surplus cash" provisions. The Court previously found the plan confirmable with these  
7 modifications. Under the proposed plan, the first deed of trust will receive a fixed rate of 7.5% interest  
8 for the term of its loan.

9 Trilex Financial Services is the holder of the second deed of trust, which it asserts is in the amount  
10 of \$3,435,315 as of July 1, 1994. The plan proposes to allow Trilex to retain its lien and to pay Trilex  
11 a variable rate of interest determined by the 11th District Cost of Funds, plus 3.75%, the same as the  
12 original note, but amortized over 30 years. The debtor's forecasts indicate that Trilex will be paid a  
13 variable rate of interest that averages 7.65% over the next 60 months. The plan also extends the term  
14 of the note from March 1997 to ten years from the Effective Date.

15 The 11th District Cost of Funds as of September 30, 1994 at 2:00 p.m. is 3.86%, thus the Initial  
16 Rate established as of the Effective Date will be 7.61%. As with the original note, the plan also provides  
17 for a floor of two percent below the Initial Rate and a ceiling of five percent above the Initial Rate.

18 The third deed of trust is held by Jim Woodson and Denny McLarry and is in the approximate  
19 amount of \$1,334,871. The plan proposes to pay Woodson and McLarry 12% interest for the term of  
20 five years.

21 Trilex objects to confirmation of the debtor's plan on the basis that the plan is not fair and  
22 equitable, is not feasible, and unfairly discriminates against Trilex, and because debtor's management  
23 cannot provide adequate management and controls.

## 24 25 **DISCUSSION**

### 26 **I. Plan Confirmation Issues**

#### 27 **A. The Plan Is Fair And Equitable In Its Treatment Of Trilex**

##### 28 **1. The Court May Build A Market Rate Of**

**Interest From A Base Rate Of 6%.**

This confirmation dispute is raised by the holder of the second deed of trust, Trilex. The primary issue presented to the court as disputed and subject to a cram down analysis is the appropriate interest rate that would provide Trilex with the present value of its secured claim.

The appropriate rate of interest on deferred payments should be the rate of interest that the debtor would pay to borrow a similar amount on similar terms in the commercial loan market. In re Camino Real Landscape Maintenance Contractors, 818 F.2d 1503, 1506 (9th Cir. 1987). To test the proposed interest rate payable to Trilex under the Plan, which averages 7.65% over the first five years according to the debtor's projections, the Court will use the formula approach approved by the 9th Circuit in the case of In re Fowler, 903 F.2d 694 (9th Cir. 1990), as explained in the case of In re Villa Diablo Associates, 156 B.R. 650 (Bankr. N.D. Cal. 1993).

The formula approach begins with establishing a base rate by identifying the center of gravity of the commercial real estate loan market by utilizing the rate of treasury obligations, the prime rate, the London Interbank Offered rate, the Eleventh District Cost of Funds index, or some other established index. Villa Diablo, 156 B.R. at 653-54. The base rate is then adjusted by adding or subtracting basis points taking into consideration various factors. Factors that affect the market rate include the nature of the loan, the value and the quality of the collateral, and the risk of default. Id. at 654.

To establish the base rate, the Court considered evidence of the cost of first deeds of trust, which appears appropriate in this case because a major factor in determining the base rate of a first deed of trust is the equity cushion available to protect the first lien. Based on the evidence submitted that shows variable rates available for first deeds of trust on comparable apartment complexes ranging from rates of 5.75% to 6.076%, the Court will build a rate by beginning with an initial base rate of 6.00%

**2. The Size And Term Of The New Trilex Note Warrants An  
Upward Adjustment To The Base Rate of Fifty Basis Points.**

In determining adjustments to the base rate, the Court starts with the nature of the loan and whether the loan structure is consistent with the marketplace. The plan proposes a variable interest rate identical in its terms to the original note acquired by Trilex, except that the ceiling and the floor have been

1 redetermined. The original loan, which was written in March 1985, also provided that the base rate  
2 would be the 11th District Cost of Funds, plus 3.75%, however, it provided for a floor of 12%. The  
3 Court notes that, as a general rule, a variable interest rate will be lower than a fixed rate because of its  
4 built-in flexibility and the reduction in risk that is inherent in fixed rate projections. Because of the  
5 fundamental differences between a variable interest rate and a fixed interest rate, much of the research  
6 provided by Trilex's expert, Mr. Sugarman, is not directly applicable to this loan because it is based on  
7 fixed rates.

8 Next, the Court recognizes that the debt structure before the Court is not standard. Accepting  
9 the fair market value of the property as \$8.4M, the loan to value ratio including the second deed of trust  
10 is not more than 73%. This loan to value ratio is much more consistent with a first deed of trust, where  
11 a standard loan would provide a 70% to 80% loan to value ratio. Because the loan is secured and the  
12 loan to value ratio does not approximate 100%, as alleged by Trilex, a substantial upward adjustment to  
13 the base rate is not warranted.

14 With respect to the fact that this actually is a second deed of trust rather than a first deed of trust,  
15 the Court notes that there appears to be very little risk inherent in this position because the strictures of  
16 a HUD loan provide for annual inspections and review of financial statements. The holders of the third  
17 deed of trust already have demonstrated the capability, willingness and intention of protecting their  
18 position by curing pre-petition defaults to the second of approximately \$350,000. The limited partners  
19 of the debtor also have an incentive to protect their initial investment of \$2.6M. However, since some  
20 adjustment appears appropriate for being in second position, the Court will add 50 basis points, resulting  
21 in an interest rate of 6.5%.

22 While there was no evidence presented on the propriety of the ten year term, the Court believes  
23 it to be within the norm of the market place for this type of a loan. Restructuring a loan over a longer  
24 period while other secured creditors are paid within a shorter period of time is permissible if the payment  
25 schedule is necessary to fit the debtor's income stream and the treatment is not otherwise unfair. In re  
26 Timber Tracts, Inc., 70 B.R. 773, 778-79 (Bankr. D. Mont. 1987). A creditor's reluctance to extend a  
27 long-term loan is not sufficient to preclude a cram down if the other requirements of § 1129 are satisfied.  
28 In re Mulberry Agricultural Enterprises, Inc., 113 B.R. 30, 32-33 (D. Kan. 1990).

The loan also calls for interest only payments for the first year and leaves open the possibility of negative amortization, but the Court notes that negative amortization is not per se prohibited. Whether a plan that provides for negative amortization is fair and equitable should be determined on an *ad hoc* basis. In re Sierra Woods Group, 953 F.2d 1174, 1177-78 (9th Cir. 1992). The Court has considered the factors set forth in In re Apple Tree Partners, 131 B.R. 380, 398 (Bankr. W.D. Tenn. 1991)<sup>1</sup> and concludes that the plan is fair and equitable with respect to its treatment of Trilex.

### 3. The Value And The Quality Of The Security Do Not Warrant Any Adjustment To The Base Rate.

With respect to the value of the property, the two appraisals that were submitted are very close. Norman Hulberg, the debtor's appraiser, determined that the value of the property is \$8,400,000. Thomas Fernwood, Trilex's appraiser, submitted a lower appraisal in the amount of \$7,800,000. Based on the evidence presented, the property has a fair market value in the amount of \$8,400,000 for purposes of confirmation. Mr. Hulberg's appraisal withstood cross-examination and is the more accurate reflection of the true value of the property because it uses Lincoln Glen as a comparable property and takes into account the reassessment of the real property taxes.

The quality of security is an important factor in determining an appropriate interest rate. The property is described as in fair to good condition in the testimony, the appraisal reports and the most recent review by HUD. The property has a vacancy factor of no more than 9%. The most important factor for the value of apartment complexes affecting rentability is the job market in the area. Both

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<sup>1</sup> A non-exclusive list of the factors that are relevant to the determination whether a negative amortization plan is fair includes:

1. Does the plan offer a market rate of interest and present value of the deferred payments;
  2. Is the amount and length of the proposed deferral reasonable;
  3. Is the ratio of debt to value satisfactory throughout the plan;
  4. Are the debtor's financial projections reasonable and sufficiently proven, or is the plan feasible;
  5. What is the nature of the collateral, and is the value of the collateral appreciating, depreciating, or stable;
  6. Are the risks unduly shifted to the creditor;
  7. Are the risks borne by one secured creditor or class of secured creditors;
  8. Does the plan preclude the secured creditor's foreclosure;
  9. Did the original loan terms provide for negative amortization; and
  10. Are there adequate safeguards to protect the secured creditor against plan failure.
- Sierra Woods, 953 F.2d at 1178 (citing Apple Tree Partners, 131 B.R. at 398).

1 appraisers described the job market in the Fremont area as strong. The Woods is a garden-style  
2 apartment complex desirably located in a middle class section of Fremont; the property is conveniently  
3 accessible to retail, recreation, and transportation near the neighborhood. The property includes tenant  
4 amenities such as laundry rooms, a swimming pool, and a recreation area. Although there are  
5 outstanding repairs, the complex is well maintained and attractively landscaped.

6 Notwithstanding the fair condition of the property, which would otherwise justify a downward  
7 adjustment to the base rate, the Court must consider the age of the complex, which is 16 years old. That  
8 the property is an older one would offset any downward adjustment based on its condition.

9 As a result, no adjustment to the base rate appears appropriate based on the value and quality of  
10 the security.

11  
12 **4. The Risk Of Default Warrants An Upward**  
13 **Adjustment Of 125 Basis Points.**

14 Lastly, the court turns to the issue of the risk of default, which is divided into two parts. The first  
15 is just the general nature of the risk. Here the property has a very thin cash flow, although the debtor is  
16 ahead of projections. The debtor does not have a great deal of equity in the property. Based upon the  
17 court's assessment, a further upward adjustment of 125 basis points appears appropriate. This results in  
18 an interest rate of 7.75%.

19 As set forth in Villa Diablo, there is also the protection afforded by the confirmation process.  
20 Assuming the debtor can meet all of the other confirmation standards, there is protection afforded by the  
21 confirmation process in that there is a determination that there is a reasonable prospect that the plan can  
22 work. Based upon that, the Court would decrease the interest rate computation by 50 basis points. This  
23 results in an interest rate of 7.25%.

24 Based upon that computation, the Court's conclusion is that the debtor would have to offer a  
25 minimum interest rate to the second deed of trust of 7.25% in order to provide Trilex with the present  
26 value of its secured claim under the terms of the Bankruptcy Code. As of the Effective Date, the plan  
27 provides Trilex with an interest rate of 7.61%. Thus, the plan provides Trilex with a market rate of  
28 interest.

**B. The Plan Is Feasible**

To be feasible under § 1129(a)(11), the plan must have a reasonable probability of success. In re Acequia, 787 F.2d 1352, 1364 (9th Cir. 1986). Feasibility has been defined as whether the things which are to be done after confirmation can be done as a practical matter under the facts. In re Jorgeson, 66 Bankr. 104, 108 (Bankr. 9th Cir. 1986). The factors relevant to this determination include the earning power of the business, the adequacy of its capital structure, economic conditions, continuation of present management, the efficiency of management in control of the business after confirmation, and any other related matter which determines the prospects of a sufficiently successful operation to enable performance of the provisions of the plan. In re U.S. Truck Co., Inc., 800 F.2d 581, 589 (6th Cir. 1986); In re Mulberry Phosphates, Inc., 149 B.R. 702, 709 (Bankr. M.D. Fla. 1993). The Court must review the totality of circumstances to determine whether the plan meets the feasibility requirement for confirmation. Mulberry Phosphates, 149 B.R. at 709.

In making its feasibility determination, the following factors are significant to the Court: the property is in fair condition and is operated by competent management; the debtor has performed deferred maintenance during the chapter 11 and has budgeted additional maintenance items to preserve the collateral; its five-year forecast is based on historical rent increases and takes into account a conservative vacancy rate; the debtor's forecasts appear to be supportable and attainable; and the debtor is ahead of its cash flow projections.

These factors all indicate that the plan appears feasible at the interest rates proposed.

**C. The Plan Does Not Discriminate Unfairly Against Trilex**

Trilex also objects on the basis that the plan unfairly discriminates by treating its secured claim differently from the other secured claims. However, paying secured creditors different interest rates and over varying periods of time does not constitute unfair discrimination where the secured creditors retain their liens and receive within a reasonable time at a market rate of interest the present value of their claims. In re Nelson, 133 B.R. 786, 794 (Bankr. S.D. Miss. 1991); In re Apex Oil Co., 118 B.R. 693, 711 (Bankr. E.D. Mo. 1990); In re Martin, 66 B.R. 921, 929 (Bankr. D. Mont. 1986). The plan does not discriminate unfairly against Trilex.

**D. The Evidence Fails To Support Trilex's Argument That The  
Debtor Cannot Provide Adequate Management And Control**

The receiver has continued to use the onsite property management employed by the debtor presumably because it has been satisfied with its services. The reorganized debtor intends to have its general partner operate the property post-confirmation. There simply is insufficient evidence that the general partner of the debtor, who manages a number of other properties, is incapable of providing adequate management and control.

**II. Trilex Is Entitled To The Excess Cash Collateral**

The Court deferred the determination of secured creditors' entitlement to the receiver's accumulation of excess cash collateral until plan confirmation in order to view the entire case in perspective. With that in mind, the Court concludes that the cash should be turned over to Trilex for the following reasons. First, such a result is consistent with the expectation of parties with respect to their rights under state law. Also, by reducing the principal on the second, it will serve to alleviate some of the negative amortization concerns and address Trilex's concern that the third will be paid in full prior to the second under the confirmed plan. Finally, payment to the second will enhance the position of the third.

**III. Woodson And McLarry's Motion For Relief From Stay Is Denied**

Finally, Woodson and McLarry moved for relief from stay for cause under § 362(d)(1) because the debtor has not made any postpetition interest payments on the third deed of trust and under § 362(d)(2) on the basis that a successful reorganization is not in prospect. Because the Court concludes that the debtor's plan is confirmable, Woodson and McLarry's motion for relief from stay is denied.

**CONCLUSION**

For the reasons stated in the record, the debtor's plan is confirmed, and Trilex's objection is overruled. The cash collateral in the possession of the receiver shall be turned over to Trilex, and Woodson and McLarry's motion for relief from stay is denied.